Fixed Income Perspectives: The battle of the mandates

Are bond investors right about US rate cuts, or will the Fed hold rates steady at the end of the hiking cycle? Watch the labor market.

Matt Toms, CFA
Global Chief Investment Officer

Lines are being drawn for a battle royale

In one corner, we have easing inflation and economic worries setting conditions for rate cuts. In the other corner, we have the labor market flexing its muscles. Oddsmakers (aka, fed funds futures) say the Fed has one more hike left before it reverses course and takes rates down by year end. Fed Chair Jerome Powell seems to have other ideas.

Bull case: Rate cuts coming as inflation and the economy show signs of fatigue

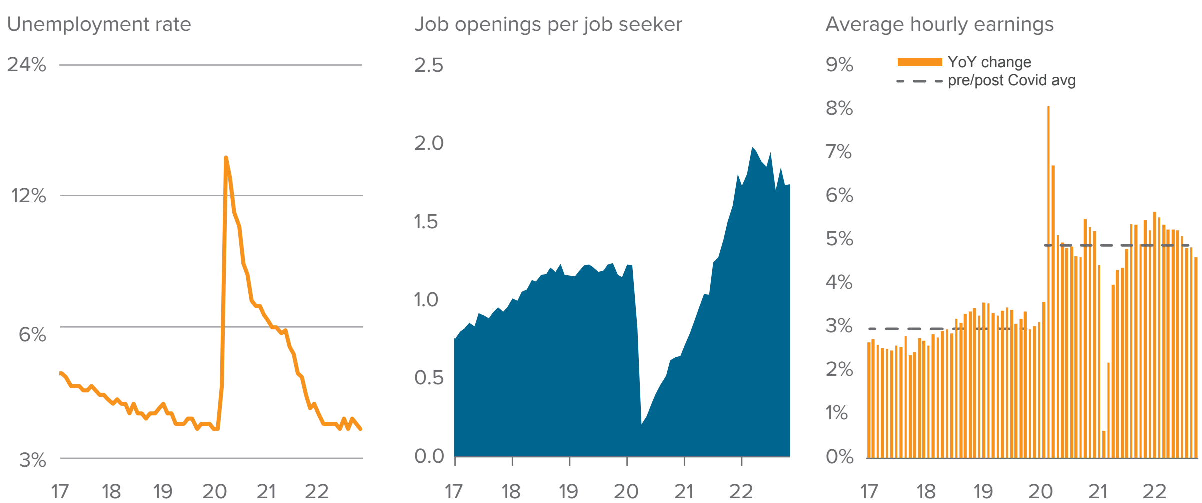
The US Consumer Price Index fell by 0.1% in December, signaling that inflation may finally be transitioning lower. Many CPI components have returned to pre-2020 levels. Prices of core goods and energy are declining, and only shelter and food prices remain stubbornly high, although these could soften according to leading indicators such as home sales, new rents and agricultural commodities markets. The US economy, though still relatively buoyant, faces worries about potential earnings downgrades and economic damage from higher rates. Meanwhile, consumers are running up credit balances despite strong wages and a high cost of financing.

Base case: Rate cuts delayed by a tight labor market

US unemployment fell to a near-record low in December and initial jobless claims are hovering above a remarkably low 200,000 per week. There are still roughly two openings for every job seeker, and wage gains remain high (Exhibit 1). Though there are early signs of labor softening — including fewer quitters and fewer assignments for temporary workers — the employment picture is robust. The question is whether job market wobbling will become big enough to induce the Fed to cut rates. Anything short of 5% unemployment feels insufficient.

Exhibit 1: Labor markets are still too strong to support Fed cuts

Unemployment remains low | Jobs remain plentiful | Wages remain elevated



Source: Bureau of Labor Statistics
Unemployment rate and Average Hourly Earnings as of 12/31/22. Job openings as of 11/30/22.

Don't hold your breath waiting for lower rates

According to the average of the Fed's "dot plots," the central bank sees no need to steer the fed funds rate lower until 2024, contrasting with futures markets suggesting several cuts before year-end. The jobs market is generally key to Fed policy, and we think today is no exception. Inflation is receding but remains stubbornly high, and most people who want a job can probably find one. The Fed is likely to guide the fed funds rate to 5–5.25% as expected, but we see little chance of a cut later this year. As we head towards a rate pause, we favor sectors that benefit from a drop in bond volatility, such as mortgages and investment grade corporates.

Bond market summary

Global rates

Global growth is strengthening, but most central banks ex-US are still in tightening mode.

Investment grade

Fundamentals remain relatively strong but valuations look expensive.

High yield

Spreads still are not pricing in enough risk for an outright buy as we expect downgrades to start picking up.

Securitized credit

We're increasingly positive on relative valuations, favoring higher quality CLOs and CMBS.

Agency RMBS

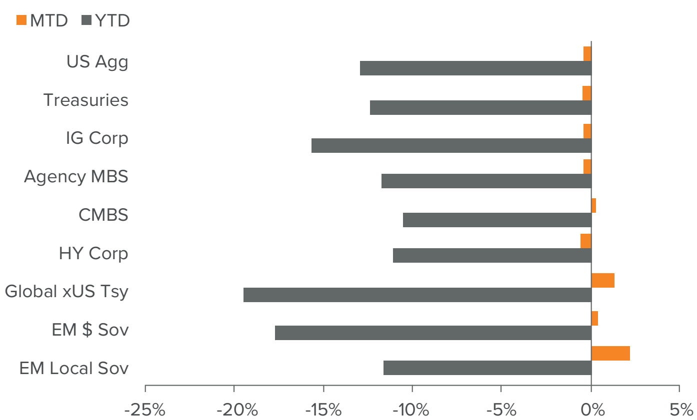
We think recent strength in agency mortgages is likely to continue into 2023.

Emerging markets

Though EMs are in good shape and inflation has peaked, valuations are a bit high for comfort.

Rates, spreads and yields

Fixed income sector total returns as of 12/31/22



		31-Dec	30-Sep	1Y Low	1Y High
Yields (%)	US 2 Yr	4.40	4.23	0.73	4.73
	US 10 Yr	3.88	3.83	1.51	4.24
	GER 10 Yr	2.57	2.11	-0.18	2.57
	JPN 10 Yr	0.42	0.24	0.07	0.48
	EM Local Sov	6.86	7.31	5.72	7.63
Spreads (bp)	IG Corp	130	159	91	165
	Agency MBS	51	69	18	88
	CMBS	193	166	102	207
	HY Corp	469	552	278	583
	HY x-Egy Corp	484	572	271	594
	EM $ Sov	453	559	359	593

As of 12/31/22. Sources: Bloomberg, JP Morgan and Voya Investment Management. **Past performance is no guarantee of future results.**

Sector outlooks

Global rates and currencies

- Growth in the US remains strong, while China and Europe economies are looking better.
- Whereas the Fed appears to be nearing its endgame, the ECB has a long way to go as it contends with spiraling wages. However, headline European inflation is set to decline given the base effect from energy.
- The key question regarding China's recent economic boost is whether growth will be inflationary due to goods demand, or disinflationary due to goods supply.

Investment grade corporates

- IG corporate spreads started the new year at the tight end of their 9-month range.
- After a quiet December, IG supply has picked up in January as expected, led by financials.
- Earnings reflect a softening of fundamentals but overall remain reasonably healthy, indicating corporations are well prepared for an economic slowdown in 2023.
- Despite favorable fundamentals, valuations look full and warrant a defensive posture, waiting for better opportunities.

High yield corporates

- The fourth quarter rally finally ran out of steam, but fundamentals are still decent, if a bit muddy.
- We believe current valuations are reasonable but don't adequately price in the risk of a potential economic slowdown.

- Weak equity markets are contributing to the stall in HY spreads, weighing on sentiment.
- Main risks to a blowout in spreads are an overly hawkish Fed, stubbornly high inflation, or a rollover in growth.
- We're overweight building products and independent energy; underweight financials and consumer cyclicals.

Senior loans

- Medium-term challenge for loans is a degraded backdrop for technicals and fundamentals.
- Decelerating earnings are not helping loan markets. We continue to trade out of weakness (shaky single B) and into strength (stronger single B).
- There were no defaults in the sector last month, leaving the 12-month trailing default rate at 72 bp, well below its historical average.
- Downgrades are accelerating, led by Moody's, triggered by earnings, margin pressure, excess leverage levels and increasing borrowing costs.
- Our portfolio is conservative now, overweight higher-quality names and maintaining a relatively high cash balance while awaiting buying opportunities.

Securitized credit

- We remain cautious on CLOs. The overhang from aging CLO warehouses improved in Q4 but remains an issue.
- We are positive on CMBS, seeing a tactical opportunity given the lack of coming supply.
- In the short term, we remain positive on RMBS. Issuance remains low, while potential demand from money managers and insurers could be substantial. Longer term, we find comfort in the fact that mortgage credit behavior is well underpinned by strong underwriting and regulatory oversight.
- For consumer ABS, we are downgrading our rating to neutral, citing full valuations following the strong rally in the fall. Nonetheless, fundamentals remain strong.
- We're net positive on securitized credit overall, though diligent underwriting is particularly important.

Agency RMBS

- Net issuance for 2023 is looking to be similar to the 2022 level of about $550 billion, with the additional supply coming from Fed runoff offset by a slowdown in organic supply.
- Demand-wise, interest rate volatility has been keeping some buyers at bay, and that could easily change in 2023.
- We rate agency MBS as positive in the near term, primarily because we believe fixed income volatility will abate, leading to tighter spreads.

Emerging market debt

- EM credit spreads bucked the trend by rallying in December on the back of a better-than-expected US CPI, China's reopening and supportive technicals.
- New issuance remained muted in December at about $3 billion across sovereigns and corporates. Relative to 2021, EM corporate issuance was down 60% and sovereign issuance was down 53% in 2022, respectively.
- EM inflation has begun to peak and central bank hiking cycles are nearing an end; inflation will remain above target in most countries and will preclude monetary easing.
- EM valuations are rich following the rally since late October. Like many markets, current levels do not price in a meaningful risk of recession.
- We remain cautious in the near term but China's reopening would be supportive for EM growth prospects.

Past performance does not guarantee future results. This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities. The opinions, views and information expressed in this commentary regarding holdings are subject to change without notice. The information provided regarding holdings is not a recommendation to buy or sell any security. Fund holdings are fluid and are subject to daily change based on market conditions and other factors.

The distribution in the United Kingdom of this presentation and any other marketing materials relating to portfolio management services of the investment vehicle is being addressed to, or directed at, only the following persons: (i) persons having professional experience in matters relating to investments, who are "Investment Professionals" as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Financial Promotion Order"); (ii) persons falling within any of the categories of persons described in Article 49 ("High net worth companies, unincorporated associations etc.") of the Financial Promotion Order; and (iii) any other person to whom it may otherwise lawfully be distributed in accordance with the Financial Promotion Order. The investment opportunities described in this presentation are available only to such persons; persons of any other description in the United Kingdom should not act or rely on the information in this presentation.

The Capital Markets Authority and all other Regulatory Bodies in Kuwait assume no responsibility whatsoever for the contents of this presentation and do not approve the contents thereof or verify their validity or accuracy. The Capital Markets Authority and all other Regulatory Bodies in Kuwait assume no responsibility whatsoever for any damages that may result from relying on the contents of this presentation either wholly or partially. It is recommended to seek the advice of an Investment Advisor.

Voya Investment Management does not carry on a business in a regulated activity in Hong Kong and is not licensed by the Securities and Futures Commission. This insight is issued for informational purposes only. It is not to be construed as an offer or solicitation for the purchase or sale of any financial instruments. It has not been reviewed by the Securities and Futures Commission. Voya Investment Management accepts no liability whatsoever for any direct, indirect or consequential loss arising from or in connection with any use of, or reliance on, this insight, which does not have any regard to the particular needs of any person. Voya Investment Management takes no responsibility whatsoever for any use, reliance or reference by persons other than the intended recipients of this insight. Any prices referred to herein are indicative only and dependent upon market conditions. Unless otherwise specified, investments are not bank deposits or other obligations of a bank, and the repayment of principal is not insured or guaranteed. They are subject to investment risks, including the possibility that the value of any investment—and income derived therefrom, if any—can increase, decrease, or in some cases be entirely lost, and investors may not get back the amount originally invested. The contents of this insight have not been reviewed by any regulatory authority in the countries in which it is distributed.

The opinions and views herein do not take into account your individual circumstances, objectives or needs and are not intended to be recommendations of particular financial instruments or strategies to you. This insight does not identify all the risks (direct or indirect) or other considerations which might be material to you when entering any financial transaction. You are advised to exercise caution in relation to any information in this document. If you are in doubt about any of the contents of this insight, you should seek independent professional advice. In addition, please be advised that Voya Investment Management is a non-Canadian company. We are not registered as a dealer or adviser under Canadian securities legislation. We operate in the Provinces of Nova Scotia, Ontario and Manitoba based on the international adviser registration exemption provided in National Instrument 31-103. Accordingly, investors will have more limited rights and recourse than if the investment manager were registered under applicable Canadian securities laws.

IM0000000 • CMMC-FIMONTHLY • 073124 • 081822 • 6301

VOYA® INVESTMENT MANAGEMENT